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ABSTRACT

The third in a series on school finance, this report describes state sales tax practices that, when coupled with individual income and property taxes, add stability and diversity to the local tax system from which public education draws its support. Figures and tables illustrate: the percent of state and local government expenditures for selected state services; the state tax revenue as a percent of the total tax revenue by type of tax; state versus local school revenues as a percent of total revenues for the school years 1976-77 to 1986-87; the association between the state share of school revenue and the state-local sales tax share of state-local revenues; and general sales tax rates. A description is presented of the setting of general sales taxation, the state and local share of school support is discussed, and the conformance of the general sales tax to general taxation principles is described. Issues of sales taxation are discussed, including the idea of softening regressivity via exemptions or credits. Finally, findings and choices for education supporters are advanced, with the following overarching theme: General sales taxation is a very important revenue source for education because it is the single largest source of state own-source general revenue as well as the largest revenue-producing state tax. Furthermore, any expansion of the general sales tax means that the states would have to extend the old tax base and protect the new one. (JAM)

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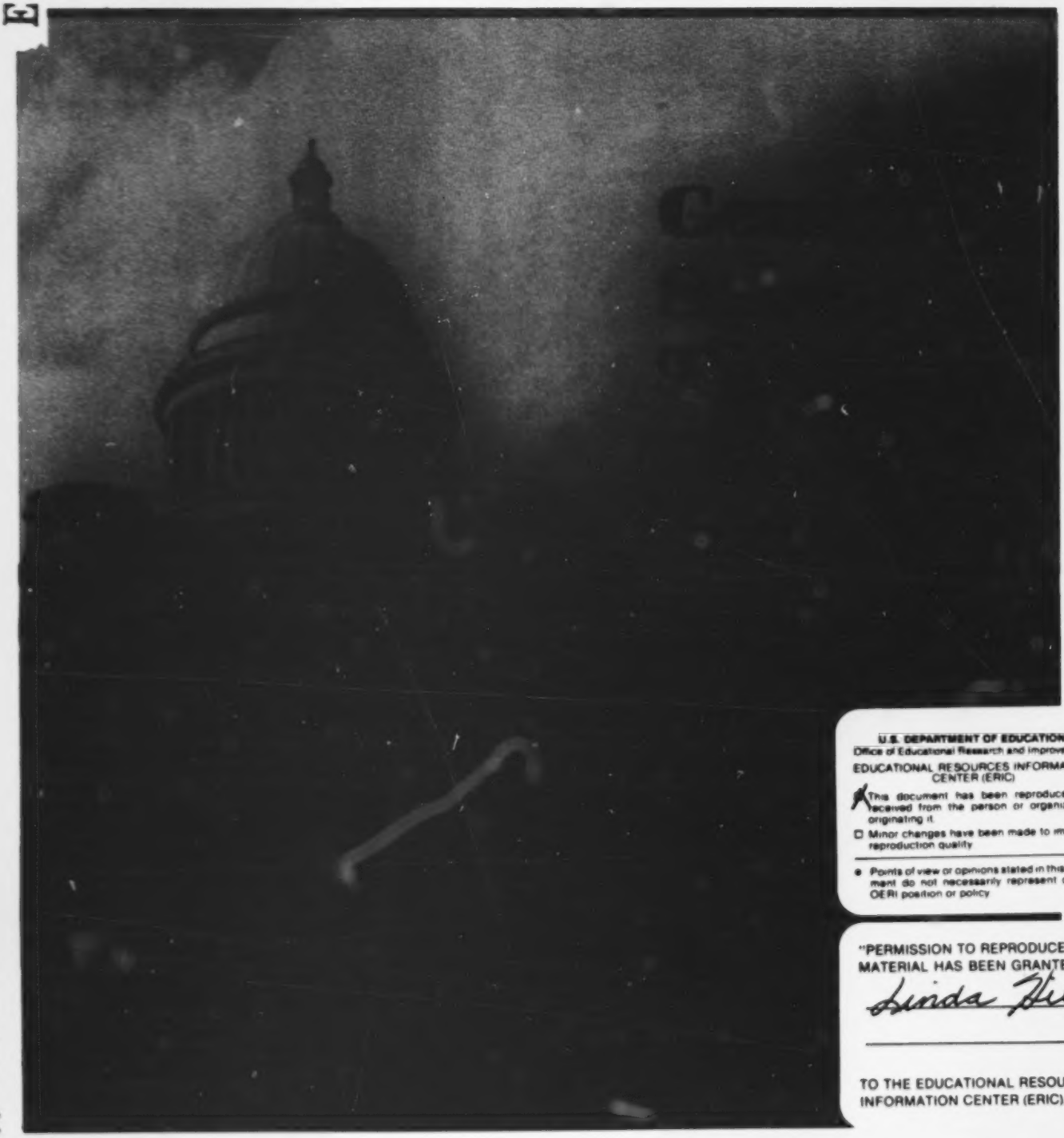

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Foreword

The general retail sales tax is a uniquely American invention. From humble beginnings in the Great Depression of the 1930s, it has grown to be a main producer of both state and local revenue in all but four states. As a major revenue source, the general retail sales tax supports many state functions, not the least of which is state assistance for local public schools. It is in this capacity that those concerned about the adequacy of support for public education should become familiar with the principles of sound sales tax practice.

Among sources of support for schools, the sales tax ranks as least abrasive to the general public. It is paid conveniently in small amounts at the time of purchase. Individuals are not required to file complicated tax returns. Techniques have been tried and proved effective in shielding low-income households from the potential regressive aspects of the tax.

When coupled with the individual income tax and the property tax, the sales tax adds stability and diversity to the state and local tax system from which public education draws its support.

This report describes tested state sales tax practices. It suggests opportunities for expanding the scope and yield of the tax to encompass more items of personal consumption without contributing to its regressive features.

The findings and conclusions of this report suggest the actions needed to enhance and maintain the general sales tax as a strong contributor to a fair, diversified, and adequate state and local tax system.

We believe that Association leaders at all levels will find this publication a useful reference document when the issue of public support for education arises and it is necessary to seek changes in the state and local tax system to obtain additional revenue.

This publication, prepared by the NEA school finance staff, is an abridged version of a manuscript by Professor John H. Bowman of Virginia Commonwealth University.

Inquiries regarding its contents may be directed to Joseph Falzon, NEA Research staff.

September 1987

The Setting

Education perennially is the largest of all state and local services, and by a wide margin (Figure 1). In 1984-85, state and local spending for education accounted for nearly three times as much spending as the next-largest service category, public welfare. Elementary and secondary education accounts for 68 percent of all education spending; thus, it is, itself, the largest state and local service responsibility.

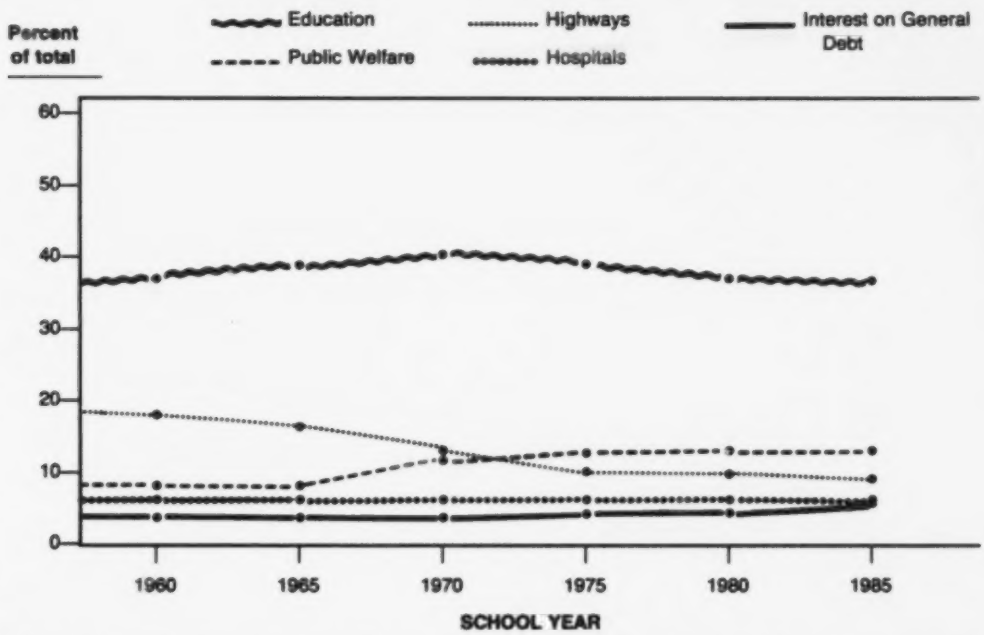
Where does this money come from?

Local school systems raise nearly one-half (43.8 percent in 1986-87) of local public schools' revenue. State and federal aid payments account for the remainder. By far the largest of these is state aid, which accounted for 50.0 percent of the total school system general revenue in 1986-87.

At the state level, the nonproperty taxes, and particularly the general sales

Figure 1.

PERCENT OF STATE AND LOCAL GOVERNMENT GENERAL EXPENDITURE FOR SELECTED FUNCTIONS: 1960 TO 1985



SOURCE: Bureau of the Census. *Governmental Finances in 1984-85.* GF85, No. 5. Washington, D.C.: U.S. Government Printing Office, 1986, Figure 6.

tax, are the primary sources of revenue for funding public education (Figure 2). The general sales tax is the largest single source of state general revenue. In 1984-85 it accounted for one-fourth of all state own-source general revenue and nearly one-third of state taxes. The general sales tax, which arose as a new form of U.S. state taxation during the Great Depression, has been the dominant state tax source since the close of World War II. It is used by 45 state governments.

School systems that are not independent units of government, such as all those in Maryland, North Carolina, Virginia, and a few systems in other states, are dependent upon "parent" governments' "contributions." Local general sales taxes are found in nine of the 16 states with dependent school districts. For these 16 states, local sales taxes account for anywhere from zero to 29 percent of all local taxes. The average is 9 percent, compared with the 11 percent national average for local governments.

Considering the role of general sales taxation in the revenue systems of the governments that provide funds to local public school systems, it is reasonable to believe that roughly 15 percent of local school funding, on average, comes from general sales taxation. Indeed, its role in funding education may be increasing because state aid has been growing relative to other sources of local public school revenue and because general sales tax revenue has been growing more rapidly than most other state revenue sources.

Figure 2.

STATE TAX REVENUE AS A PERCENT OF TOTAL TAX REVENUE BY TYPE OF TAX

*At the local level, some amounts of corporate income tax revenues are reported as personal income taxes by the Census Bureau.

SOURCE: U.S. Department of Commerce, Bureau of the Census. *Governmental Finances in 1984-85.* GF85, No. 5. Washington, D.C.: Government Printing Office, 1986, Table 6.

State and Local Share of School Support

Education Spending: State Share Rising

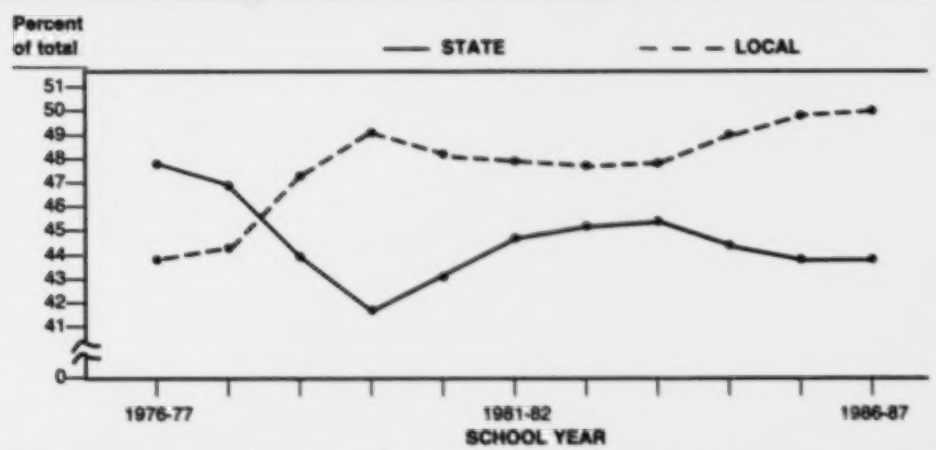
Why is an increasing share of local school revenue being raised beyond the local level? There are two basic reasons. One is to provide equal-education opportunity. The amount of local tax available on a per pupil basis differs substantially, so that some revenue equalizing from a higher level of government is necessary. Revenue equalizing was the focus of the *Serrano* case and related equal-protection cases in the 1970s. These cases spurred a major boost in the state share of education support. The second reason for greater state support is that local schools provide benefits that extend beyond the local area. Such external benefits serve to depress local education spending below socially desirable levels unless offset by aid from a higher level of government—i.e., nonlocal dollars should pay for the nonlocal benefits.

The state share of state and local support of local public schools varies greatly. The range in 1986-87 was from a low of 7 percent in New Hampshire to a high of 99 percent in Hawaii. Both of these are outliers, particularly New Hampshire: the next-lowest state share was four times as large as New Hampshire's (Nebraska, at 29 percent), and the second-highest state share was more than 10-percentage points below Hawaii (New Mexico, 87 percent). In four states, the state share was under one-third, and it was above two-thirds in 13.

The long-term increase in the state share has not been smooth (Figure 3).

Figure 3.

STATE VS. LOCAL SCHOOL REVENUES
AS PERCENT OF TOTAL REVENUES, SCHOOL YEARS 1976-77 TO 1986-87



SOURCE: National Education Association, Research Division, *Estimates of School Statistics*. Washington, D.C.: The Association, 1987.

Whither the Sales Tax?

Sales tax states derived anywhere from 20 to 59 percent of all state taxes from sales taxation in 1985, with the average for 45 states being 35 percent (Table 1). How close is the association between the percentage of state tax revenue derived from general sales taxation and the state share of education support?

Visual inspection of these two sets of percentages reveals no apparent relationship. Only three of the top 10 states, on the basis of the state share of education support, are in the 10 top sales tax-dependent states. Similarly, only four states with the lowest state share of education support are among the states that have little or no reliance on the sales tax.

What emerges from inspection of the state role in funding public schools is an impression of rather strong geographic patterns. These geographic patterns are the result of a mix of revenue preferences and tax diversification that reflect the economic realities within a state more than a preference for reliance on the sales tax to support public schools.

On average, general sales taxation is important to state government finance and state aid is important to local public school support. The differences among the states on both these matters are sizable and rather persistent. Yet, it is difficult to discern a strong aggregate relationship between state reliance on general sales taxation and the state role in supporting local public schools.

TABLE 1. The Association Between the State Share of School Revenue and the State-Local Sales Tax Share of State-Local Revenue

	State school revenue as a percent of all state-local school revenue 1985	State-local sales tax as a percent of all state-local taxes 1985
NEW ENGLAND		
Connecticut	42.3	26.7
Maine	55.3	22.9
Massachusetts	47.6	14.4
New Hampshire	66.2	0.0
Rhode Island	40.5	19.2
Vermont	38.8	11.8
MIDEAST		
Delaware	74.7	0.0
Dist. of Col.	100.0	21.1
Maryland	41.5	15.4
New Jersey	44.6	17.1
New York	45.8	19.2
Pennsylvania	47.8	18.4
SOUTHEAST		
Alabama	79.9	29.9
Arkansas	69.9	33.4
Florida	57.4	34.9
Georgia	61.4	28.2
Kentucky	78.0	21.3
Louisiana	59.0	37.9
Mississippi	65.7	38.9
North Carolina	68.1	22.3
South Carolina	64.6	28.1
Tennessee	56.2	47.4
Virginia	36.0	16.7
West Virginia	70.8	34.1
GREAT LAKES		
Illinois	43.8	24.8
Indiana	61.1	32.5
Michigan	35.1	17.4
Ohio	48.9	22.1
Wisconsin	35.9	18.9
PLAINS		
Iowa	45.6	19.7
Kansas	45.6	20.1
Minnesota	60.0	18.3
Missouri	42.7	34.0
Nebraska	28.9	19.8
North Dakota	58.3	20.2
South Dakota	30.1	31.0
SOUTHWEST		
Arizona	71.0	37.1
New Mexico	86.8	39.7
Oklahoma	69.9	25.4
Texas	49.1	24.9
ROCKY MOUNTAINS		
Colorado	41.0	29.8
Idaho	65.5	23.2
Montana	53.3	0.0
Utah	58.8	32.7
Wyoming	42.2	16.7
FAR WEST		
Alaska	81.5	2.2
California	73.9	28.0
Hawaii	99.9	39.3
Nevada	44.2	34.3
Oregon	29.4	0.0
Washington	78.6	47.9

SOURCES:

National Education Association. *Estimates of School Statistics.* Washington, D.C.: the Association, 1987.

U.S. Dept. of Commerce, Bureau of the Census. *Governmental Finances in 1984-85.* GF85, No. 5. Washington, D.C.: U.S. Government Printing Office, 1986, Table 29.

Conformance to Taxation Principles

Is the general sales tax a good tax? This question is important because of the large role of this tax in current state-local tax systems and, historically and probably prospectively, in generating increased state and local revenue.

Few Complaints

One measure of a good tax is its popularity, or its lack of opposition. The "art" of taxation has been likened to the goal in plucking a goose, "gathering the most down with the least amount of hissing." On this basis, general sales taxation fares well. A recent public opinion survey found the sales tax preferred to other taxes if additional revenues had to be raised, whether at the national, state, or local level. This view prevailed, although to varying degrees, among all age, sex, race, income, education, regional, and other groups. But this same annual survey found public opinion to be somewhat variable when asked what tax is "worst" or "least fair." From 1972 through 1984, between 13 and 23 percent of respondents named the state sales tax.

Why the Sales Tax Is Popular

Other criteria besides its popularity may be more important in evaluating the sales tax as opposed to other taxes. These criteria may also help us to understand (and perhaps influence) public opinion. Lists of evaluative criteria differ, but generally include equity, efficiency, administrative and compliance ease, certainty, adequacy, and stability.

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Equity. The fairness, or equity, of a tax is one of the most basic considerations. Equity, like beauty, is in the eye of the beholder. One basic approach to equity is *benefits-based*: a tax is equitable when individuals' tax burdens are at least roughly proportionate to their public service benefits. The distribution of the tax burden on behalf of education cannot be benefits-based. The public service benefits of education are difficult to quantify because they are spread among individuals, their families and friends, and, indeed, society in general. Another approach is *ability-to-pay*, which represents the more common concept of equity applied to taxes.

In practice, income is the most commonly used measure of ability to pay taxes, although property ownership and consumption outlays are reasonable measures of ability. Effective tax rates that measure tax as a percentage of income are used to evaluate ability-based equity. A tax that takes an increasing percentage of income as income rises is a *progressive* tax. If effective tax rates fall as income rises, the tax is a *regressive* tax. If the effective rate is the same at all levels of income, the tax is *proportional*.

Evaluation of tax burdens under both the benefits- and ability-based notions of equity is complicated by the fact that those who legally must pay a tax to the government (tax impact) often are not the ones whose real incomes ultimately are reduced by that tax (tax incidence). Incidence is the important consideration. If the merchant is legally responsible for paying a sales tax, for example, but is able to pass it along to customers through higher prices, then impact and incidence differ—the tax has been shifted.

What is the situation for the general sales tax? (See Table 2 for tax rates.) On the assumption that the tax is borne by consumers in proportion to their consumption expenditures, most analysts conclude that the general sales tax is regressive. An estimate for 1985, for example, shows an overall effective rate of 3.4 percent of income, although ranging from 7.0 percent for the population decile with the lowest-income level to 1.9 percent for the highest-income decile. Estimates for each of the 45 sales tax states in 1983 show all of them to be regressive.

Sales taxation tends to be regressive because it applies principally to goods, as opposed to services, including several categories of goods that are, to a degree, necessities. Consumption in general, but particularly consumption of goods, takes a larger percentage of income at lower-income levels than at higher ones. Thus, even with a flat tax rate applied to all taxable purchases, the sales tax is regressive.

Efficiency. A tax that induces behavioral changes is not neutral with regard to economic choices. Economists have demonstrated that consumers are made worse off, for any given amount of revenue to be raised, by a non-neutral tax than by a neutral tax. Not only is the tax money given up, but consumption patterns are moved away from the most preferred choice, which reduces consumer satisfaction still more. The additional loss of consumer satisfaction that results from distorting choices, rather than from the amount of the tax, is termed an inefficiency. Efficiency is the absence of waste, and a non-neutral tax produces waste by directing resources to less-valued choices.

A completely neutral tax is one that cannot be escaped by any change in activity. No tax capable of producing

large amounts of revenue is completely neutral. The best that can be done is to reduce the non-neutralities. In general, neutrality increases with the breadth and uniformity of coverage.

A general sales tax is more neutral than a selective sales tax such as a tax on gasoline, alcohol, or tobacco. However, the so-called general sales tax is not completely general because each state excludes some items from the tax. Common exclusions from the tax base include prescription drugs, food for at-home consumption, and most services (see Table 3).

Administrative and Compliance Ease. Another source of inefficiency, or waste, is the needlessly high costs of making the tax work. These costs fall into two groups. Those assumed by the tax agency are called *administrative costs.* Costs incurred by others are *compliance costs,* sometimes expressed in terms of *convenience.*

Governments emphasize administrative costs much more than compliance costs because they must budget only for the administrative costs. Both costs are important, though, for both represent uses of society's scarce resources.

Compliance costs—those associated with recordkeeping and the remission of collections to the government—apparently are higher than administrative costs for general sales taxation. Exempt sales of such items as food and essential clothing tend to increase compliance costs.

Certainty. Like convenience of compliance, certainty of a tax makes life easier for the taxpayer. The notion is that the tax amount should be known to the taxpayer. The general sales tax scores well against this criterion. The tax is paid at the time of purchase and (usually) without recording consumer identity. Retroactive tax rate changes cannot be used in general sales taxation. Merchants remit taxes frequently and with certainty as to liability.

Adequacy. Can the tax base raise the amount of money required to provide the services for which a government is responsible and do so at an acceptable rate? If so, the tax is said to be adequate. At issue is tax capacity in relation to expenditure need. Need and fiscal capacity do not lend themselves to absolute measurement. Moreover, for any one tax, this consideration is of less importance for governments with diversified tax structures than for those with only one tax source.

A more important consideration is the dynamic aspect of tax adequacy. As the economy grows, does revenue growth from the tax keep pace with growth in the demand for the services to be financed? Demand for public services seems to grow more rapidly than the level of economic activity. General sales tax revenue, on average, grows roughly at the same rate as income. This helps to explain the historic upward drift of sales tax rates.

Stability. The final attribute usually considered important for taxes is stability, or predictability. This is particularly important for state and local governments, which typically must balance their budgets. Sales tax revenues are fairly predictable, largely because consumer spending levels remain relatively stable although income may vary. Sales tax yields tend to vary less than income tax yields. The predictability of the sales tax yield in each state varies, depending upon the coverage of the tax. Different elements in the tax base fluctuate more or less closely with changes in economic conditions.

Issues of Sales Taxation

Having reviewed the financing role of the general sales tax and considered it against the major evaluative criteria to determine its viability, some issues surrounding the tax can be examined. These issues cut across many of the criteria presented in the previous section and relate principally to revenue productivity.

Tax Exporting. Ability to export taxes produces a sales tax base that is larger than the purchases by residents of the taxing unit. Under the traditional assumption that sales tax incidence is borne by the consumers, part of a jurisdiction's sales tax falls on nonresidents as they shop, eat in restaurants, or stay in hotels or motels in that jurisdiction. Tourism is more likely to give rise to significant sales tax exporting at the state level. Thus, tourism provides one means of exporting sales taxes. Another arises from a state government structure with numerous local jurisdictions, so that people who live in one jurisdiction often shop in another. This latter problem is greatest for local taxes, although it also is present for state taxes along state lines.

Another avenue for exporting a state sales tax is taxation of business purchases. Although coverage of such purchases varies widely, all sales tax states tax some business purchases, which may account for 15 to 25 percent of the sales tax base. Depending upon the market conditions facing firms, these sales taxes will either be absorbed by the businesses' owners or be shifted to their customers or resource suppliers. To the extent that the burdened groups are comprised of nonresidents, the business sales tax is exported.

Is tax exporting bad? Perhaps the best answer is, "It depends."

Governments "import" some costs when they provide services to nonresident tourists, shoppers, and workers, so it is appropriate that those governments receive some revenues from those nonresidents. It would be extreme coincidence, however, if tax exporting and cost importing exactly matched. To the extent that exported taxes exceed the increased costs incurred to serve nonresidents who pay those taxes, exporting is undesirable because it is unfair to nonresidents, and it exerts an economically inefficient upward pressure on revenues and spending.

Border Effects. Just as self-interest leads jurisdictions to try to export taxes, it leads consumers to try to avoid taxes. Thus, a relatively high sales tax rate may reduce the sales tax base. This is a non-neutrality, or inefficiency—a distortion of shopping patterns—caused by the change in relative prices associated with tax differences. Consumers find such tax avoidance to their advantage where low-tax options exist, provided the tax saving is enough to offset any additional cost to take advantage of them. Such loss of tax base through distortion of shopping patterns is termed a border effect, and is the flip side of tax exporting: one jurisdiction's exported tax is another's loss of tax base.

Fear of business loss from high-tax areas produces interjurisdictional tax competition, which tends to suppress tax rates for all jurisdictions. Because local jurisdictions encompass smaller areas, borders are more numerous and travel costs associated with avoiding a high tax are relatively low; therefore, the border problem is more severe locally than at the state level. For this reason, many have concluded that sales taxation is ill-suited to local governments absent a statewide uniform rate.

But local sales taxes are found in about three-fifths of the states, and the number of local governments employing them now approaches seven thousand (Table 2). Border effects are minimized by widespread application of the local tax and little or no variation in local rates. Where a single uniform local rate blankets the state (as in Virginia), the local tax is indistinguishable from an additional state levy.

Tax Consciousness. Compared to either an income tax or a property tax, the average sales tax payment is quite small and, therefore, relatively painless. And unlike an income tax, the sales tax places no requirement on individuals to maintain careful records or to file returns. As a result, individuals tend not to be very conscious of their sales tax burden. This no doubt helps to explain the relative popularity of sales taxation in public opinion surveys. And it enhances the revenue productivity of the general sales tax, helping to maintain it as the largest source of state tax revenue over several decades.

With the exception of the tax placed on business purchases, however, sales taxes are not hidden. Indeed, they typically appear on a cash register tape or bill of sale as a separate item. A hidden tax results in low tax consciousness and may produce a larger public sector than otherwise would be sustainable.

Tax Elasticity. For high revenue production and long-term revenue adequacy without the need for periodic rate increases, high income-elasticity is desirable. Elasticity of the general sales tax is a function of the effects of both real growth and inflation.

TABLE 2. General Sales Tax Rates

	State sales tax rate (percent) on	
	6/1/87	9/1/81
Alabama (a)	4	4
Alaska (a)		
Arizona (a)	5	4
Arkansas (a)	4	3
California (a)	4.75	4.75
Colorado (a)	3	3
Connecticut	7.5	7.5
Delaware		
Dist. of Columbia	6	6
Florida (a)	5	4
Georgia (a)	3	3
Hawaii	4	4
Idaho	5	3
Illinois (a)	5	4
Indiana	5	4
Iowa (a)	4	3
Kansas (a)	4	3
Kentucky	5	5
Louisiana (a)	4	3
Maine	5	5
Maryland	5	5
Massachusetts	5	5
Michigan	4	4
Minnesota (a)	6	5
Mississippi	6	5
Missouri (a)	4.225	3.125
Montana		
Nebraska (a)	4	3
Nevada (a)	5.75	5.75
New Hampshire		
New Jersey	6	5
New Mexico (a)	4.75	3.5
New York (a)	4	4
North Carolina (a)	3	3
North Dakota	5	3
Ohio (a)	5	4
Oklahoma (a)	4	2
Oregon		
Pennsylvania	6	6
Rhode Island	6	6
South Carolina	5	4
South Dakota (a)	5	4
Tennessee (a)	5.5	4.5
Texas (a)	5.25	4
Utah (a)	5.1	4
Vermont	4	3
Virginia (a)	3.5	3
Washington (a)	6.5	4.5
West Virginia	5	5
Wisconsin (a)	5	4
Wyoming (a)	3	3

(a) = local sales tax permitted.

SOURCE: Commerce Clearing House, Inc. *State Tax Guide: All States.*

Real growth and inflation may not produce equivalent revenue changes. It is important, in considering how changing levels of economic activity affect sales tax performance, to consider how the base responds to inflation.

Because general sales taxes are not truly general, whether inflation results in increased, decreased, or unchanged sales tax revenue depends upon the sensitivity of quantity demanded to price changes. For inflation to produce additional revenue requires that demand be price-inelastic. Price-inelasticity means that the percentage change in quantity demanded is less than the percentage change in price. This being the case, a sales tax increase resulting in higher price will not cause a drop in tax revenue. Conversely, price-inelastic demand means that the percentage change in quantity is greater than the

TABLE 3. Treatment of Categories of the State Sales Tax Base, 1986

	FOOD	OTHER CONSUMER GOODS			CONSUMER SERVICES	
		Rx Drugs	Utilities	Clothing	Mainly Taxable	Mainly Exempt
ALABAMA (a)	T	E	T	T		•
ALASKA (a)						
ARIZONA (a)	E	E	T	T		•
ARKANSAS (a)	T	E	E	T		•
CALIFORNIA (a)	E	E	E	T		•
COLORADO (a)	E	E	E	T		•
CONNECTICUT	E	E	E	E		•
DELAWARE						
DIST. OF COLUMBIA	E	E	T	T		•
FLORIDA (a)	E	E	E	T		•
GEORGIA (a)	T	E	T	T		•
HAWAII	T	E	T	T	•	
IDAHO	T	E	E	T		•
ILLINOIS (a)	E	E	T	T		•
INDIANA	E	E	T	T		•
IOWA (a)	E	E	T	T		•
KANSAS (a)	T	E	E	T		•
KENTUCKY	E	E	E	T		•
LOUISIANA (a)	E	E	E	T		•
MAINE	E	E	E	T		•
MARYLAND	E	E	E	T		•
MASSACHUSETTS	E	E	E	E		•
MICHIGAN	E	E	T	T		•
MINNESOTA (a)	E	E	E	E		•
MISSISSIPPI	T	E	T	T		•
MISSOURI (a)	T	E	E	T		•
MONTANA						
NEBRASKA (a)	E	E	T	T		•
NEVADA (a)	E	E	E	T		•
NEW HAMPSHIRE						
NEW JERSEY	E	E	E	E		•
NEW MEXICO (a)	T	T	T	T	•	
NEW YORK (a)	E	E	E	T		•
NORTH CAROLINA (a)	T	E	E	T		•
NORTH DAKOTA	E	E	E	T		•
OHIO (a)	E	E	E	T		•
OKLAHOMA (a)	T	E	E	T		•
OREGON						
PENNSYLVANIA	E	E	E	E		•
RHODE ISLAND	E	E	E	E		•
SOUTH CAROLINA	T	E	E	T		•
SOUTH DAKOTA (a)	T	E	T	T	•	
TENNESSEE (a)	T	E	E	T		•
TEXAS (a)	E	E	E	T		•
UTAH (a)	T	E	E	T		•
VERMONT	E	E	E	T		•
VIRGINIA (a)	T	E	E	T		•
WASHINGTON (a)	E	E	E	T	•	
WEST VIRGINIA	E	E	E	T	•	
WISCONSIN (a)	T	E	E	T		•
WYOMING (a)	E	E	E	T		•

(a) = local sales tax permitted.

SOURCE: Based on data in Commerce Clearing House, Inc., *State Tax Guide: All States.*

percentage change in price. If demand is elastic, revenue will fall as a consequence of inflation. Demand generally is least elastic for necessities. But many necessities are outside state sales tax bases, including shelter, food, and prescription drugs (Table 3).

A study of the behavior of one state's sales tax base components found that total sales tax collections were reduced by higher inflation rates, principally because of the performance of durable goods. By contrast, increased inflation was associated with increased sales tax revenue from sales of food, whether for at-home use or away from home.

Thus, the responsiveness of sales tax revenue to changes in aggregate economic activity depends very much on the composition of the tax base. And it is not the case that a broader base necessarily means a more income-elastic tax.

Base Definition. The discussion of revenue elasticity suggests that in defining the sales tax base there is a tradeoff between revenue adequacy in the short-run and in the long-run. Short-run, the broader the tax base, the more revenue any given rate will produce. But long-run, where the focus switches to the rate of automatic revenue growth, a very broad base likely will retard revenue growth because base-broadening will bring in base components that are income-inelastic. Base composition also affects the stability of the sales tax.

Other base composition issues, beyond their implications for revenue productivity, principally involve equity and efficiency concerns. One such issue is the taxation of *business purchases.* All states exclude at least the raw materials and component parts used in the manufacture of products, and many go beyond this to exclude business machinery and equipment and certain other items used directly in the production process. The trend is toward the broader exclusion, but the differences among the states in the tax status of purchases by businesses are considerable. Some business purchases are taxable in all sales tax states.

Inclusion of business purchases has been defended as fair by some, who argue that if individuals have to pay taxes on their purchases of clothes, cars, and tools, then businesses also should. This ignores the distinction between consumer and producer goods, as well as the fact that all taxes ultimately are borne by individuals in their capacities of consumers, resource suppliers, or business owners. Tax incidence, not impact, is the critical question in evaluating fairness. When the initial impact is on business, final incidence is likely to be more capricious, and it certainly is more difficult to determine.

Probably the most important obstacle to removing business purchases from the sales tax base, as a practical matter, is the potential revenue loss. If, as suggested earlier, most state sales taxes generate 15 to 25 percent of their revenue from business purchases, removal of the tax on these purchases would represent a significant revenue loss, or would require a substantial tax rate increase in the sales tax, or another tax to avoid the loss.

Aside from business purchases, the issues about base composition involve *consumer purchases.* The range of consumer goods included in the general sales tax base is becoming narrower (see Table 3). The major argument favoring exemption of the various categories of consumer goods is equity, and the major obstacle to such exemption is

revenue loss. The same cannot be said for failure to tax consumer services. Their taxation generally would improve equity, but it also would entail higher administrative and *compliance* costs, as well as political opposition to the disruption of the status quo.

Softening Regressivity—Exemptions or Credits

One of the major arguments against the use of the sales tax is its regressivity. The sales tax can be made essentially proportional over a broad income range either by exempting food, or by providing a credit against the state income tax, or by a direct refund of some part of the sales tax.

The exemption of food for at-home consumption is said to reduce sales tax revenue by 15 to 20 percent, making it the largest of the consumer exemptions. This and the perception that all food purchases are necessities have made food exemption a much-debated aspect of base definition.

Eight states—Hawaii, Idaho, Kansas, New Mexico, South Carolina, South Dakota, Vermont, and Wyoming—use the less costly income tax credit or refund. Moreover, several states have abandoned the credit/refund approach in favor of the exemption, presumably on the grounds of taxpayer convenience.

Under the credit approach, food remains taxable, and the taxpayer receives a credit against the state income tax (or a direct refund by government check) equal to some part of the sales tax. Exemption removes all food from the sales tax base on the argument that food is a necessity. But not all food is necessary. As some have described the results of the food exemption—to exempt the poor man's beans, the rich man's lobster also is exempted. The food exemption thus sacrifices too much revenue and creates a non-neutrality that favors those who favor food over other goods and services.

The credit, by contrast, can be set equal to the tax rate, times some amount of necessary food consumption per person, times the number of persons. Credits sometimes are made more complex than this. To increase progressivity, some advocate reducing the size of the credit as income rises.

In keeping with the rationale that the sales tax is a tax on consumption, the presumption should be for the broadest possible coverage of consumer purchases, including services as well as goods, and against their exemption. To the degree that higher income groups can and do spend a larger portion of their income on services, the extension of the sales tax to services will bring it more in line with the ability to pay concept of tax equity.

Findings and Choices for Education Supporters

Currently, there exists a system of revenue source separation among governmental levels in the United States. Although income taxation is used at all three levels of government and general sales and property taxes are used at both the state and local levels, over 80 percent of all income tax revenue is federal, over 80 percent of all general sales tax revenue is state, and over 95 percent of all property tax revenue is local.

General sales taxation is a very important source of revenue for education because it is the largest single source of state own-source general revenue, as well as the largest revenue-producing state tax.

Tax Diversification

Several decades ago, state governments tended to have either a general sales tax or a broad-base personal income tax, now 37 states have both. Diversifying the state tax structure to include both these major taxes offers advantages. Neither tax exists in ideal form; gaps in coverage exist that give rise to inequities and inefficiencies. By using both taxes, a state broadens the reach of its tax system and makes it more difficult to avoid the responsibility to help pay for state services. In this way, too, any given level of state revenue can be raised at lower rates, and this helps to minimize the importance of the inequities and the inefficiencies in sales and income taxes.

If more state revenue is to be raised for education, for example, several considerations bear on the choice between income and sales taxes. If the amount of money to be raised is quite substantial and the state in question uses only one of these taxes, adoption of the other probably is preferable. For lesser amounts of money, the added costs to taxpayers and to government from another type of tax may not be warranted. Even in this situation, though, the advantages of diversification should not be overlooked. Because most states already have both a general sales tax and a broad-base personal income tax, however, when additional revenue is sought, the choice is which of the two to increase.

Extending the Tax Base

Extension of the sales tax base to consumer services would reduce existing non-neutralities between goods and services. To the extent that services are provided by merchants who already sell taxable items, administration and compliance costs also would be reduced. Examples include automobile repair and other repair operations, where the tax usually applies to parts but not to labor. A major extension of the sales tax base in Florida (where there is no personal income tax) gave that state the broadest coverage of services. It would tax most services, including those of accountants, architects, and lawyers, but excluding medical care, insurance, day care, and some agricultural and financial services.

Protecting the Tax Base

In seeking additional revenue from the sales tax, the rate must be increased, or the base must be broadened, or both. The trend among the states has been to erode the sales tax base while increasing the tax rate. This adversely affects equity, efficiency, administration and compliance costs, and border effects. For these reasons, a real effort should be made to halt and even reverse this trend.

The public popularity of the sales tax assures its continued role as a mainstay of state and local government finance. The National Education Association and its state and local affiliates should seek to protect the revenue adequacy of the tax by guarding against enactment of legislation that would further erode the base or add to whatever regressive features of the tax that now exist.

ERRATUM

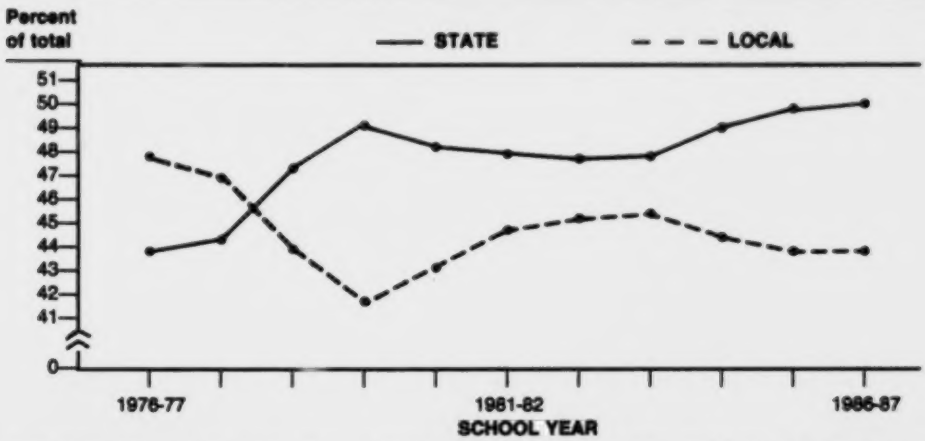
General Sales Taxation — SEARCH Publication

The lines drawn on the State vs. Local School Revenues figure on page 7 are reversed. Please insert the corrected chart below in your copy of the publication.

NEA Research

Figure 3.

STATE VS. LOCAL SCHOOL REVENUES
AS PERCENT OF TOTAL REVENUES, SCHOOL YEARS 1976-77 TO 1986-87



SOURCE: National Education Association, Research Division, *Estimates of School Statistics*. Washington, D.C.: The Association, 1987.

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